SUBJECT INDEX.

PAGE

Opinions Below 3

Jurisdiction 4

Question Presented 4

Statutes Involved 4

Statement 4

Argument 7

The decision in this case is not in conflict with any decision of any other Circuit Court of Appeals relating to the same matter 7

The decision of the Circuit Court is in conformity with the unambiguous terms of the statute 10

The change in the Revenue Act of 1932 regarding the percentage depletion allowance is new law and has no retrospective effect 13

Conclusion 15

TABLE OF AUTHORITIES CITED.

CASES.

	PAGE
Bogle & Co., 5 B. T. A. 541	11
Brewster v. Gage, 280 U. S. 327	14
Burnet v. Harmel, 287 U. S. 103	11
Burnet v. Niagara Falls Brewing Co., 282 U. S. 648	14
Comar Oil Company v. Burnet, 64 Fed. (2d) 965, 78 Law Ed. 76	9, 11
Darby-Lynde Co. v. Alexander, 51 Fed. (2d) 56, 284 U. S. 666	7, 11
Ginsberg & Sons v. Popkin, 285 U. S. 204	11
Gould v. Gould, 245 U. S. 151	12, 14
Hecht v. Malley, 265 U. S. 144	14
Lynch v. Alworth-Stephens Co., 267 U. S. 364	11
Russell v. U. S., 278 U. S. 181	14
Von Baumbach v. Sargent Land Co., 242 U. S. 503	11
U. S. v. Biwabik Mining Co., 247 U. S. 116	11
U. S. v. Magnolia Petroleum Company, 276 U. S. 160	14
U. S. v. Updike, 281 U. S. 489	14

STATUTES.

Judicial Code, section 240(a), as amended by the Act of February 13, 1925	4
Revenue Act of 1926, Sec. 204(c) (2)	4, 6, 10, 11, 12, 13, 14, 15
Revenue Act of 1926, Secs. 213, 214, 212, 233, 234, 232	11
Revenue Act of 1932, Sec. 114(b) (3)	13

INDEX TO APPENDIX.

	PAGE
Statutes Involved	17
Regulations 69, Art. 203	22
Regulations 69, Art. 204	23
Regulations 69, Art. 221	21
Revenue Act of 1926, Sec. 204(a)	17
Revenue Act of 1926, Sec. 204(b)	17
Revenue Act of 1926, Sec. 204(c)	17
Revenue Act of 1926, Sec. 204(c) (2)	18
Revenue Act of 1926, Sec. 212(a) (232(a))	18
Revenue Act of 1926, Sec. 213(a)	19
Revenue Act of 1926, Secs. 214(a), 234(a) (1)	20
Revenue Act of 1926, Sec. 214(a) (9), Sec. 234(a) (88)	20
Revenue Act of 1926, Sec. 233(a)	19
Revenue Act of 1932, Sec. 23(1)	21
Revenue Act of 1932, Sec. 114(b) (3)	18

IN THE

SUPREME COURT

OF THE

UNITED STATES.

OCTOBER TERM, 1934.

No. 170.

Guy T. Helvering, Commissioner of Internal Revenue,

Petitioner,

vs.

Twin Bell Oil Syndicate,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

Opinions Below.

The opinion of the Board of Tax Appeals [R. 14-27] is reported in 26 B. T. A. 172. The opinion of the Circuit Court of Appeals [R. 192-214] is reported in 70 F. (2d) 402.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered April 12, 1934. [R. 215.] The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

Whether, in determining the gross income for the purpose of applying the provisions of Section 204(c) (2) of the Revenue Act of 1926, which provides for a deduction for depletion based on 27½ per cent of gross income, the taxpayer's actual gross income should be reduced by rentals and royalties paid.

Statutes Involved.

The statutes and regulations involved are contained in the Appendix hereto.

STATEMENT.

The facts as found by the Board and as stipulated (in part) by the parties are as follows:

The taxpayers is a California syndicate organized in 1922 for the purpose of acquiring a certain oil and gas lease and operating it. [R. 36-41.] Both the Board and the court below have held that the syndicate is to be treated as a corporation for Federal income-tax purposes.

The original lessee of the properties was one F. A. Andrews, who secured a twenty-year lease from the owner,

W. O. Batson, in December, 1921. In addition to certain monthly rentals to be paid until drilling should commence the lessee agreed to pay as rental or royalty for the land "one-sixth (1-6) of all oil produced and saved therefrom, said payment to be made in money or in kind at the lessor's option." [R. 86-90.]

On February 10, 1922 this lease was assigned by F. A. Andrews to Thomas H. Lipps. The agreement or assignment contained the provision that, in addition to the payment of the one-sixth royalty specified in the original lease, the lessee would pay a one-twelfth royalty to the lessor. [R. 95-97, 197.]

On April 25, 1922, Lipps assigned all his right, title and interest in the lease to the trustees of the syndicate, who agreed to comply with all of the terms and conditions of the original lease and also of the assignment by Andrews. [R. 103-105.]

The taxpayer has never acquired any property other than the lease assigned to it by Lipps and has never sold any part of such lease. The taxpayer had a contract under which it sold all the oil produced to the Associated Oil Company. [R. 42.] The taxpayer entered on its books the payments received from the sale of its oil in an "Oil Runs Account" and charged against such account the royalties paid to Batson and Andrews. [R. 49-50.]

The one-sixth royalty and the one-twelfth royalty paid to Andrews during the taxable years 1925, 1926 and 1927 were as follows [R. 18]:

Year	Batson Royalties	Andrews Royalties
1925	$159,853.20	$79,926.60
1926	143,253.02	71,626.51
1927	70,946.34	35,473.17

In the audit of the taxpayer's returns for 1925, 1926 and 1927, the Commissioner held that the above-mentioned royalties should be deducted from the gross income from the wells before computing the 27½ per cent deduction for depletion allowed under Section 204(c) (2). [R. 18-19.]

The Commissioner determined deficiencies as the result of this adjustment of the depletion allowance and other adjustments and the taxpayer appealed to the United States Board of Tax Appeals.

The Board sustained the Commissioner's allowance for depletion, but decided against the Commissioner on another issue. Both parties appealed. The Circuit Court of Appeals for the Ninth Circuit reversed the Board on the issue concerning depletion, which was one of two issues in the taxpayer's appeal . The Circuit Court held that the 27½ per cent deduction should be computed on the gross income of the taxpayer without deduction for the rents and royalties. The other issues involved in the case were decided for the Government and are not here involved.

ARGUMENT.

The Decision in This Case Is Not in Conflict With Any Decision of Any Other Circuit Court of Appeals Relating to the Same Matter.

In his brief, petitioner contends that the decision of the Circuit Court in this cause is in conflict in principle with the decision of the Circuit Court of Appeals for the Tenth Circuit in the case of *Darby-Lynde Co. v. Alexander*, 511 Fed. (2d) 56, *certiorari* denied, 284 U. S. 666. The issue in the *Darby-Lynde Co.* case was the question of whether income realized from the sale of oil properties should be considered as gross income upon which the depletion allowance might be based. The issue, therefore, did not involve the same matter as is involved in the instant proceeding. However, in reaching a conclusion in that case, the Court, in its Opinion, reviewed the law concerning the depletion allowance. Although the petitioner interprets the Court's decision as being in conflict with the decision of the Circuit Court in this Twin Bell Oil Syndicate case, we respectfully submit that the Court's decision is not only *not* in conflict but actually supports the Opinion of the Court in the instant case, and in support of our conclusion we respectfully call attention to that part of the Court's Opinion in the *Darby-Lynde Co.* case which reads as follows, 51 Fed. (2d) 56, on page 59:

> "In order to reach a reasonable and rational result, *the words 'gross income' as used* in sec. 204(c)(2) *must be construed as meaning the gross income produced from the operation of such oil and gas wells.* The language is clearly susceptible of the construction that it is income from or out of the property itself; not out of its sale.

"The legislative history of the 1926 act confirms this view. In the Revenue Acts of 1921 and 1924, in cases of oil and gas wells, Congress had provided, with certain limitations, for a depletion allowance based upon discovery value. See section 214(a) (10) and section 234(a) (9), Revenue Act of 1921 (42 Stat. 241, 256) and section 204(c), Revenue Act of 1924 (26 USCA § 935 note). When Congress wrote the provision for depletion allowance in the case of oil and gas wells in the Revenue Act of 1926, it departed from the discovery value basis because of the difficulty of administration. The discussions before the Senate Finance Committee, where the amendment which ultimately became section 204(c) (2), 26 USCA § 935 (c) (2) originated, discloses that the framers of this legislation had in mind operating income as distinguished from income derived from sales. See report of hearings before that committee, pages 153, 154, 177 and 179.

"We conclude that the words 'gross income,' as used in section 204 (c) (2), supra, mean income derived from the sale or other disposition of oil and gas produced, and not from the sale of the oil and gas properties." (Italics ours.)

In the instant proceeding the Circuit Court for the Ninth Circuit concluded that the term "gross income," as used in Section 204(c) (2), must be construed as the income derived from the sale or other disposition of oil and gas produced, and in this conclusion the decision of the Court is entirely consistent with the decision in the *Darby-Lynde Co.* case.

The only other decision which is at all related to the issue involved in this proceeding is the decision of the

United States Circuit Court of Appeals for the Eighth Circuit in the case of *Comar Oil Company v. Burnet*, 64 Fed. (2d) 965, 967-968, *certiorari* denied, 78 Law Ed. 76, October 9, 1933. That case did not involve the exact issue which is involved in this proceeding but the Government did raise the contention in that case, as in this case, that the amount of the royalties paid by a lessee to a lessor should not be considered part of the income of the lessee. The Circuit Court, in ruling upon this contention, used the following language:

> "It will be apparent upon examination of the statute (section 213(a)) that the term 'gross income' is broad in scope; broad enough to include, in the case of a lessor, rents or royalties paid to him by the lessee (cases cited); *broad enough also to include, in the case of a lessee, rents or royalties paid by him to the lessor owner; and the practice has been to include them as gross income in the return.* (Cases cited.)
>
> "It is one of the contentions of petitioners that these overriding royalties should be treated in the same manner as the original royalties. We think this contention is sound in so far as it results in the inclusion of both the original royalties and the overriding royalties in the category of 'gross income.'
>
> "We are not insensible to the forceful argument of petitioner that neither original royalties nor overriding royalties should be included in gross income of the lessee, sublessee, or transferee. The argument is one, however, which we think should more properly be presented to the Congress than to the courts. The inclusion of royalties in the gross income of the lessee not only finds support in the language of

sections 233 and 213 of the Revenue Act of 1921 but also in the actual practice as established during a considerable number of years."

From the above it is apparent that the decisions at present are without conflict in the conclusion that for depletion purposes the term "gross income" includes the income derived from the sale of oil and gas produced, which includes the amounts of rents or royalties paid by a lessee to a lessor.

The Decision of the Circuit Court Is In Conformity With the Unambiguous Terms of the Statute.

The provision of the Revenue Act of 1926 relating to the percentage depletion allowance reads as follows:

Section 204(c) (2)—

> "In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

The Commissioner's contention is, in effect, that the lessee's "gross income" is the proceeds from the sale of oil and gas produced, reduced by the amount of royalties which the lessee pays, out of these proceeds, to the lessor. There is no authority for such a conclusion.

The law is well established that royalties paid by a lessee to a lessor constitute rental payments for the use of property and, for income tax purposes, represent income to the lessor who receives them, and deductions to the lessee who pays them. (*Von Baumbach v. Sargent Land Co.*, 242 U. S. 503; *U. S. v. Biwabik Mining Co.*, 247 U. S. 116; *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364; *Burnet v. Harmel*, 287 U. S. 103; *Bogle & Co.*, 5 B. T. A. 541, 552.)

The gross income to the lessee is the total proceeds derived from the sale of oil and gas produced. (*Darby-Lynde Co., supra; Comar Oil Co., supra.*) From this gross income the lessee deducts royalties paid, as one of the deductions to be taken from gross income to arrive at the net income. (Sec. 213, 214, 212, 233, 234, 232, Revenue Act of 1926—*Bogle & Co. v. Commissioner, supra.*)

This is exactly the manner in which the taxpayer, the Twin Bell Oil Syndicate, treated the proceeds from the sale of its oil and gas and the royalties paid on its books and records, as set out in the preceding STATEMENT.

Section 204(c) (2) above quoted prescribes that the arbitrary percentage depletion allowance shall be "27½ per centum of the gross income." Whether this section is read alone or in conjunction with any or all other provisions of the Revenue Act of 1926 (*Ginsberg & Sons v. Popkin*, 285 U. S. 204), its terms are so plain and definite that they cannot be said to be ambiguous, and they cannot

be given any other meaning than that clearly imparted by the words used.

The very interpretation contended for by the Commissioner refutes his argument that the statute supports such a contention. In other words, to sustain the Commissioner's interpretation, Section 204(c) (2) must be construed to read:

> "In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year" *excluding from such gross income an amount equal to any rents or royalties.*

To construe a statute in such a manner as to require an addition of a specific exception or exclusion clause, to exclude something controlled by the plain and general terms of the statute, is like substituting a negative for an affirmative provision of a statute. There is no rule of statutory construction which would permit of such an interpretation of a statute. Statutes are not to be extended by implication beyond the clear import of the language used, or enlarged so as to embrace matters not specifically pointed out. (*Gould v. Gould,* 245 U. S. 151.)

From a study of the statute the conclusion is inevitable that for depletion purposes the gross income must include the total proceeds received from the sale of oil and gas produced from taxpayer's property and cannot be reduced by amounts of royalties paid for the use of the property.

The Change in the Revenue Act of 1932 Regarding the Percentage Depletion Allowance Is New Law and Has No Retrospective Effect.

The change in terminology in Section 114(b) (3) of the Revenue Act of 1932, which corresponds to Section 204(c) (2) of the Revenue Act of 1926 and Section 114(b) (3) of the Revenue Act of 1924, shows very clearly the force of the lower court's decision in this proceeding. Section 114(b) (3) of the Revenue Act of 1932 reads as follows:

> "In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, *excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect to the property.*"

The portion in italics is a new provision not contained in the earlier acts. Since it is a provision for exclusion of matter otherwise included in the general language of the rest of the sub-section, it must be construed as an amendment of the old law, and it is indicative of the appreciation by Congress of the effect of the section as it was constructed in the earlier Revenue Acts. The added provision in the above section might well be considered a legislative recognition that under the prior acts the gross income was not to be adjusted by the exclusion of royalties paid. The change in this section is too significant a

change of phraseology, and too much alters the ordinary meaning of the section as it was constructed in the earlier Revenue Acts, to support any contention that the amendment should be considered a clarification of the section as it was contained in the earlier Revenue Acts. (*Hecht v. Malley*, 265 U. S. 144, 156.) Where such a significant change exists as to result in a different meaning than could be assignable to the words used in the prior statute, the amended statute will be deemed to be an enactment of new law, establishing rules for the future, and will not be applied retrospectively. (*U. S. v. Magnolia Petroleum Company*, 276 U. S. 160, 162; *Brewster v. Gage*, 280 U. S. 327; *Russell v. U. S.*, 278 U. S. 181.)

In this connection, even if there should be any doubt as to the interpretation of the provisions of this statute (Section 204(c) (2)), or as to the connotation of the terms used, and another meaning might be adopted, the fact of their use in a tax statute would incline the scale to the construction most favorable to the taxpayer. (*Gould v. Gould, supra; U. S. v. Updike*, 281 U. S. 489; *Burnet v. Niagara Falls Brewing Co.*, 282 U. S. 648.)

CONCLUSION.

We respectfully submit that the provisions of Section 204(c) (2) of the Revenue Act of 1926 are clear and unambiguous and are correctly interpreted by the court below in its decision in this case. The precise question is not at this time of general importance since it arises only in the tax computations of those taxpayers engaged in the production of oil and gas and affects only the years controlled by the Revenue Acts of 1926 and 1928, and there is no conflict of decisions which requires review. The petition should be denied.

Respectfully submitted,

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August, 1934.

APPENDIX.

Statutes Involved.

REVENUE ACT OF 1926:

Section 204(a).

"The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—"

Section 204(b).

"The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be (A) the cost of such property (or, in the case of such property as is described in paragraph (1), (4), or (5), of subdivision (a), the basis as therein provided), or (B) the fair market value of such property as of March 1, 1913, whichever is greater. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date."

Section 204(c).

"The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—"

Section 204(c) (2).

"In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph." (Section 114(b) (3) of the Revenue Act of 1928 contains the same provision of Section 204(c) (2) of the Revenue Act of 1926 above quoted.)

REVENUE ACT OF 1932:

Section 114(b) (3).

"*Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

REVENUE ACT OF 1926:

Section 212(a) (232(a)).

"In the case of an individual the term 'net income' means the gross income as defined in section 213, less the deductions allowed by sections 214 and 206."

Section 233(a).

"In the case of a corporation subject to the tax imposed by section 230 the term 'gross income' means the gross income as defined in sections 213 and 217 . . ."

Section 213.

"For the purposes of this title, except as otherwise provided in section 233—

(a) The term 'gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivisions (b) of section 212, any such amounts are to be properly accounted for as of a different period."

Section 214(a) (and 234(a) (1)).

"In computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity; . . ."

Section 214(a) (9) (and Sec. 234(a) (88)).

"In computing net income there shall be allowed as deductions:

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; . . ."

REVENUE ACT OF 1932:

Section 23 (1).

"*Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. . . ."

REGULATIONS 69:

Article 221.

"Under Section 204(c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or the value at the basic date, as the case may be . . ."

Article 203.

"Amount returnable through depletion and depreciation deductions in the case of lessee.—(a) In the case of a lessee, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions and minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, and minus (4) the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation. The provisions of this paragraph do not apply to the computation of the depletion allowance in the case of oil and gas wells when such allowance is based on the income from the property.

(b) The values of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

(c) The value of a lessee's equity, if acquired prior to March 1, 1913, is to be taken to mean (1) its cost or (2) the value of his interest in the mineral as of that date, whichever is greater.

(d) The value of a lessee's equity in a proven mineral property acquired on or after March 1, 1913, is to be taken to mean its cost.

(e) The value of a lessee's equity in a discovery after February 28, 1913, is the fair market value at date of

discovery, or within 30 days thereafter, of his equity in the mineral discovered."

Article 204.

"*Amount returnable through depletion and depreciation deductions in the case of lessor.*—(a) In the case of a lessor, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value of his equity in the property at the basic date minus (2) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, plus (3) subsequent allowable capital additions, and minus (4) the value of the land at the basic date for other purposes than mineral production and the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation. The provisions of this paragraph do not apply to the computation of the depletion allowance in the case of oil and gas wells when such allowance is based on the income from the property.

(b) The values of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

(c) The value of the lessor's equity in the case of a mineral property not under lease on March 1, 1913, but subsequently leased, is to be taken to mean (1) the cost or (2) the *en bloc* value of the mineral in the ground on March 1, 1913, whichever is greater, and will, in the absence of satisfactory evidence to the contrary, be pre-

sumed not to exceed the value as of March 1, 1913, of the royalties to be expected under the lease.

(d) The value of a lessor's equity in a mineral property under lease March 1, 1913, for the entire operating life of the mineral deposits is to be taken to mean (1) the cost of (2) the value as of March 1, 1913, of the royalties and other payments to be expected under the terms of the lease in effect on that date, whichever is greater.

(e) The value of a lessor's equity in a mineral property under lease March 1, 1913, for a portion of its operating life is to be taken to mean (1) the cost or (2) the value as of March 1, 1913, of the royalties expected from the mineral to be extracted during the life of the existing lease plus the estimated *en bloc* value of the mineral remaining at its expiration, which, in the absence of satisfactory evidence to the contrary, will be presumed not to exceed the value as of March 1, 1913, of royalties which could have been expected as at that date from the remaining mineral.

(f) The value of a lessor's equity in a mineral property when acquired on or after March 1, 1913, is to be taken to mean its cost.

(g) The value of a lessor's equity in a discovery after February 28, 1913, is the fair market value at the date of discovery, or within 30 days thereafter, of his equity in the mineral discovered."